Testimony
of
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before the
Federal Deposit Insurance Corporation
on the Wal-Mart Application
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I welcome the opportunity to testify on the Wal-Mart's application to, but must correct the record in one respect. I am not representing the American Enterprise Institute. As an organization, AEI does not take positions on issues; it simply supports scholars working in various areas, and these scholars express their own views. The views in this statement, accordingly, are my own.

Because Wal-Mart will establish or acquire an industrial loan company exempted from the definition of "bank" under Section 1841 of the Bank Holding Company Act, there is no legal restriction on its acquisition by Wal-Mart. Those who oppose the Wal-Mart application argue that, despite the absence of any legal bar, the FDIC should nevertheless reject the application because it violates a purported national policy that commerce should be separated from banking.

The point I want to make today is that, if there was ever such a policy, it was abandoned when Congress adopted the Gramm-Leach Bliley Act of 1999. To be sure, there are those—even members of Congress—who claim that the GLB Act did not say anything of the kind. But with all due respect, they do not fully understand what Congress did in enacting the GLB Act. The act cannot be read in any other way except as a statement by Congress that the dangers associated with mixing banking and commerce are no longer of concern. The balance of my testimony will be addressed to this point.

The separation of banking and commerce is not an old idea or some kind of time-honored principle; it first appeared in a Federal Reserve report to Congress in 1938. Before that, banks and commercial firms were often combined. Chase Bank, indeed, began as a water company in New York, and even today a bank and a commercial firm may be jointly controlled by an individual. Nevertheless, the Bank Holding Company Act (BHCA), which was first adopted in 1956 and amended in 1970 to cover one-bank holding companies, may have been based upon the notion that banking and commerce should be separated. The act prohibited banks from affiliating through holding companies with any business that was not "closely related to banking."

Since US economic policy does not generally prevent cross-industry acquisitions, this provision of the BHCA must have had some policy basis. There must have been some harm or harms that the framers of the act had in mind. Proponents of separating banking and commerce have always justified the policy underlying the BHCA by citing three different potential dangers associated with affiliations between banks and commercial firms:

• A bank with a commercial affiliate will lend preferentially to its affiliate—either at a concessional interest rate or on terms that would not be offered at arms'length—whether willingly or under duress from its commercial parent;

• A bank with a commercial affiliate will *not* lend to competitors of its commercial affiliate, thus distorting competition and credit allocation; and

• If a bank's commercial affiliate encounters financial difficulty, the bank's resources will be marshaled to bail it out, using insured deposits for this purpose and thus jeopardizing the health of the deposit insurance funds and the bank's own safety and soundness. Sometimes this idea is expressed as extending the bank safety net to commercial firms.

The first two grounds suggest that the separation idea is based on the notion that the suppliers of credit—at least credit supported by federal deposit insurance—should be separated from the users of credit. The underlying idea is that bank credit is a valuable commodity and its allocation can be distorted by the bank's owner. The third ground suggests that separation is necessary to protect the safety and soundness of the bank and hence the financial condition of the deposit insurance fund.

All three issues were brought clearly to the attention of Congress by Paul Volcker in testimony to a subcommittee of the House Banking Committee in 1997: "We should want decisions on the allocation of credit . . . to reflect unbiased financial judgments, free of taint of serving the interests of a commercial affiliate. . . . How likely would it be, for instance, that a bank affiliated with a powerful retail chain will eagerly lend to a local or regional competitor? .. . What about the temptations to lend to or otherwise support a weak commercial affiliate?" [1]

Many others made the same points in similar testimony, in both the House of Representatives and Senate.

It is not my purpose here to assess the validity of these arguments, even though I believe they are entirely fallacious. As you know, banking regulations prohibit all these abusive uses of a bank, and impose severe personal penalties (in extreme cases, fines of up to $1 million per day) on bank managers and directors if they misuse the bank's assets for the benefit of an affiliated company. Accordingly, the likelihood that a bank's management would open itself to these penalties in order to help an affiliate attain greater profitability or avoid default seems vanishingly small.

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[1] Subcommittee on Financial Institutions and Consumer Credit of the House Banking Committee, *Statement of Paul A. Volcker*, 105th Cong., 1st Sess., February 25, 1997.

But it is not really necessary to consider the likelihood that any of these dangers will come to pass. In adopting the GLB Act, Congress in effect—despite Mr. Volcker's warnings—determined that none of these dangers or abuses is a sound basis for prohibiting affiliation between banks and other kinds of enterprises that are major users of credit.

The GLB Act broadened the range of activities with which banks could be associated, permitting affiliations with securities firms and insurance companies and any other firm engaged solely in financial activities. This, however, was not a minor change; when considered in light of the policy reasons for separating banking and commerce, *there is no significant difference between a bank's affiliating with a firm engaged solely in financial activities or affiliating with a purely "commercial" firm such as Wal-Mart*. This can easily be seen by considering how the policy reasons underlying the separation idea would apply to an affiliation between a bank and, say, a securities firm.

Assuming its management were willing to violate banking laws and regulations, could a bank lend preferentially to its securities affiliate? Of course.

And could a bank refuse to lend to competitors of its securities affiliate? Again, certainly. Indeed, securities firms need and use more bank credit than most commercial firms because they use bank loans to carry their inventories of securities.

So if a securities firm controls or is under common control with a bank, that affiliation could affect the bank's lending policies, just as it might if the bank were controlled by, say, Wal-Mart. Again, it is not necessary for purposes of this statement to dispute the likelihood that this will happen, since Congress—by permitting the affiliation—must have concluded that the likelihood is not great enough to warrant a prohibition on affiliations between securities firms and banks.

But if Congress thought banks should be permitted to affiliate with securities firms—large users of credit—what is left of the policy basis for separating the suppliers of credit from the users of credit? The answer is: not much, and certainly not enough to justify the FDIC in turning down the Wal-Mart application solely on this basis.

And finally, if the securities firm that controls or is under common control with a bank got into financial difficulties, could its affiliated bank be importuned to bail it out? Of course. And would the same thing be true in the case of the retailer? Again, yes.

So is there any difference—*from the perspective of the harms or abuses that the separation of banking and commerce is intended to prevent*—between a bank affiliating with a securities firm and the same bank affiliating with a retailer like Wal-Mart? It seems obvious that the answer is no.

If this is true, the rationale—the policy foundation—underlying the separation of banking and commerce was completely undermined by the GLB Act. If every abuse or potential abuse that is supposed to provide the basis for the separating banking and commerce could occur if banks are affiliated with securities firms—which Congress permitted in the GLB Act—what basis could there be for prohibiting affiliations with retailers? Or for that matter with automobile manufacturers, oil companies, or software developers?

The answer, it seems, is that there is no remaining rational basis for the distinction; it is completely arbitrary. Thus, by opening the door to affiliations between the suppliers of credit—i.e., banks—and the users of credit—i.e., securities firms, insurance companies, and other firms engaged in financial activities—the GLB Act did far more than simply widen the circle of activities with which banks could be affiliated under federal law.

In effect, it was a statement by Congress that there was no longer any basis for believing that affiliations between the suppliers of credit and the users of credit represent a danger to either to the bank, or to the economy generally.

Indeed, when finally reached in 1999, this was an entirely rational conclusion; the economy had changed considerably since the idea of separating banking and commerce was formally written into law with the adoption of the Bank Holding Company Act in 1956. At that time, and until the late 1970s, banks faced very little competition as suppliers of credit. Banking relationships were vital to companies and individuals, and the competition among banks was gentlemanly. By reason of their centrality to the financial system, banks had real market power.

All that changed, however, with the advent of new communication and data processing technology in the 1980s, which permitted the financial data of borrowers to be quickly transmitted and assessed in the public securities market. This eroded the principal value-added of banks' intermediary role—their special knowledge about the financial condition of borrowers; and in the case of the very strongest and largest corporate borrowers, banks' advantage virtually disappeared.

With easy and inexpensive access to borrowers' financial information, securities firms, insurance companies, pension funds, and other financial institutions were able to compete effectively with banks as providers of credit. The elimination of interest rate controls on deposits, and the repeal of restrictions on interstate banking and branching, also placed banks in direct competition with one another for both liabilities (deposits) and assets (loans to borrowers).

Thus, in today's world, as in 1999 when the GLB Act was adopted, it would be foolish if not suicidal for a company that controlled a bank to require the bank to lend preferentially to the parent company or one of its affiliates. The loan would represent a loss to the bank, apart from a violation of the law and banking regulations. Similarly, causing a subsidiary bank *not* to lend to a competitor of the parent would provide no benefit to the parent, because the competitor could always find credit elsewhere. And overreaching the bank to bail out a parent that was in financial difficulties would bring serious personal liabilities to the bank officials who agreed to the arrangement.

But my central point is that is that even if we disregard the law and regulations, once Congress agreed to allow banks to affiliate with securities firms and insurance companies it must have decided that the policy reasons for separating banking and commerce no longer apply. If that’s true, the FDIC is certainly not bound to implement a policy that Congress has abandoned.